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Coming Home to Europe: Greece and the Euro

The European Council's recent decision that Greece is ready to join EMU at the beginning of 2001 raises a number of questions. How was Greece able to comply with the convergence criteria? What are the costs and benefits of its accession from both the Greek and the present EMU members' perspectives? Is the current process of economic reform in Greece sustainable?

When European Monetary Union (EMU) began in 1999 Greece was the only country in the European Union (EU) that wanted to join the euro club but was not allowed to. Greece did not comply with the convergence criteria. However, only two years later in June 2000 the European Council made the final decision that Greece is ready to join EMU. On January 1, 2001 Greece is going to achieve its long-standing goal of full monetary integration in Europe.

Greece's membership of EMU has a wider symbolism. In the early 1990s "...it became fashionable to portray Greece as an awkward partner or indeed a black sheep in the European Union" because of its economic mismanagement and frequently non-cooperative spirit in political matters.[1] Greek admission to the euro zone indicates that after a long process of democratization and economic reforms Greece has become – in economic and political terms – a country like any other member of the European Union. Greece is finally coming home to Europe.

Greece's admission to the euro club raises several questions. How was Greece able to comply with the convergence criteria? What are the costs and benefits of EMU from the Greek perspective? Do the benefits of the Greek admission to EMU outweigh the costs from the perspective of the current EMU members? In particular, is the current process of economic reform in Greece sustainable? We address these questions in the following.

The Greek Way into the Euro Zone

In 1992, when the Maastricht Treaty was negotiated to establish the legal framework for EMU, Greece was the country with the greatest adjustment problems among the EU member countries.[2] Inflation and fiscal deficits were well above the EU average, while the Greek economy grew more slowly than that of the EU (see Figures 1-3). This difficult economic situation was the consequence of very expansionary economic policies during the 1980s.[3] Public consumption was increased by a policy of deficit spending. The expansionary fiscal policy was supplemented by a loose monetary policy leading to high inflation and a steady depreciation of the drachma. Wages were automatically adjusted to price increases through an indexation scheme, which led to further pressures on prices and devaluations of the drachma. The increasing current account deficits could only be financed by means of EU transfers and foreign loans.

In 1992 the interplay of two factors brought a turning point in Greek economic and European policy.[4] Firstly, at the beginning of the 1990s it became increasingly evident that economic policies had failed. Both the Greek public and the policy-makers realized that the stop-and-go policies of the 1980s had not only failed to deliver steady economic growth and to secure high employment. On the contrary, they had produced high inflation, a stagnant economy, high unemployment, and growing fiscal deficits. It was a

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[1] L. Tsoukalis: Greece: Like Any Other European Country?, The Hellenic Observatory, LSE, London 1999, http://www.lse.ac.uk/Depts/European/hellenic/greece.htm.

[2] P. Kazakos: Verzögerungen und Inkonsistenzen in der griechischen Konvergenzpolitik der 90er Jahre, in: M. Papaschinopoulou (ed.): Griechenland auf dem Weg zur Europäischen Wirtschafts- und Währungsunion, Schriftenreihe des Europa-Kollegs Hamburg 24, Baden-Baden 1999, pp. 77-97; A. Kotios: Konvergenzkriterien und makroökonomische Anpassung in Griechenland: Visionäres und Realisierbares, in: M. Papaschinopoulou (ed.), op.cit., pp. 99-124.

[3] An exception was the short period of stabilization policy in 1986/1987.

[4] L. Tsoukalis, op.cit.; L. Papademos: Greece and the Euro, Speech delivered at the 9th Frankfurt European Banking Congresss, http://www.greece.gr/BUSINESS/OnCourseForEMU/PapademosEnd.stm.

necessary precondition for the introduction of a new adjustment policy that the ruling socialist party (PASOK) gave up this old fashioned Keynesian style policy after 1993.

Secondly, the high popularity of the idea of Greek participation in the EMU and the pro-European attitude of the majority of the Greek public made the policy change easier. The adoption of the common currency and the common monetary policy was seen as a means to end the national mismanagement of monetary and economic policy. The fear of being left behind in a less integrated, "second class" group of countries made it necessary to rethink Greece's policy towards the European Union.

Figure 1
Inflation

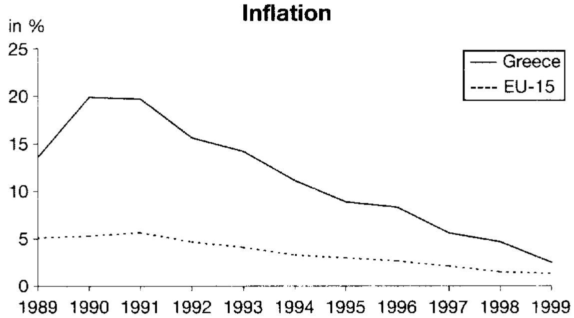


Figure 2
Fiscal Deficit

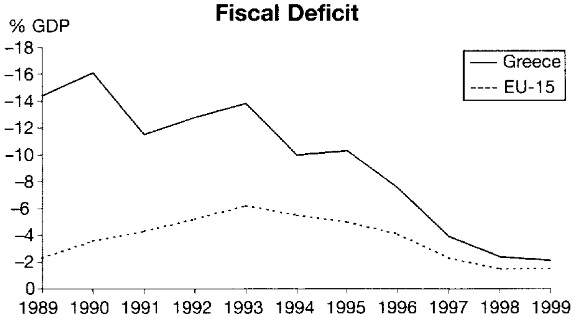
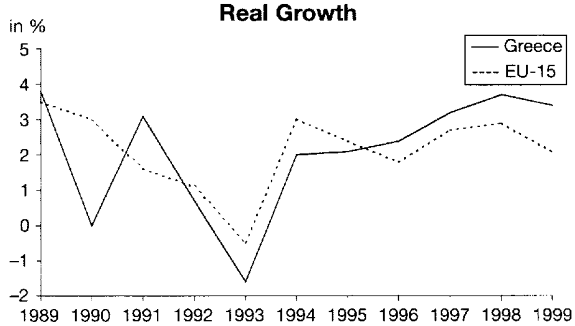


Figure 3
Real Growth



When the new government came into office after the elections in autumn 1993, it introduced a new convergence program for the period 1994-1999 according to the requirements of Article 116 (2a) Treaty on European Community (TEC). Greece committed itself to an ambitious macroeconomic stabilization policy in order to reduce inflation from 10.8% (1993) to 3.3% (1999), to restrict the budget deficit from 13.2% of GDP (1994) to 2.1% of GDP (1999) and public debt from 112% of GDP (1994) to 103% (1999). Greece was determined to comply with the exchange-rate criteria by 1997 and to reduce long-term interest rates from 19.5% (1994) to 2.1% (1999).

This first phase of convergence policy (1994-1997) was characterized by an inconsistent and inappropriate policy mix.[5] On the one hand adjustment policy was based on higher tax revenues, high interest rates and a real revaluation of the drachma. On the other hand the government continued its expansionary income policy and did not cut real consumptive public expenditures. Structural reforms necessary to improve supply-side conditions were postponed. While the convergence program brought a considerable improvement in macroeconomic performance, it was not enough to bring Greece into line with the convergence criteria by the end of 1997.

As it became evident that Greece would not be allowed to join EMU with the first wave of entrants, the government revised its convergence plan in December 1997.[6] The aim of the new convergence program was to fulfill the convergence criteria by the beginning of the year 2000, so that Greece would be able to join EMU by 2001, one year before euro coins and bills are to replace national currencies.

The revised convergence plan brought further improvements in monetary and fiscal policy. With respect to monetary policy, the Greek central bank was granted independence, thereby fulfilling one of the EMU requirements.[7] In order to comply with the exchange-rate criterion Greece joined the European Monetary System (EMS) in March 1998. At the same time the drachma was devalued by 12.3% relative to the ECU. With the start of EMU Greece joined the successor of the old EMS, the newly created Exchange Rate Mechanism II.

[5] A. Kotios, op.cit., pp. 116-117.

[6] Hellenic Ministry of National Economy and Finance: The 1998 Update of the Hellenic Convergence Programme: 1998-2001, Athens, June 1998.

[7] M. Papaschinopoulou: Institutional Adaptation at the Bank of Greece in View of Stage Three of EMU – A Case Study on Central Bank Interdependence, in M. Papaschinopoulou (ed.), op.cit., pp. 209-236.

The major goal of fiscal policy was to cut fiscal deficits and debt. Public consumption was reduced relative to GDP and public wage expenditures were restricted. The lower inflation helped to bring down long-term interest rates, so that interest payments on public debt fell from 12% of GDP in 1996 to 9% in 1999.[8] The combined effect of lower deficits, revenues from privatizing state enterprises, and higher real growth has led to a continuous reduction in debt relative to GDP since 1997.

The macroeconomic part of the Greek convergence program was supplemented by several structural reforms in the years 1998 and 1999. A process of labor market liberalization was initiated, several state enterprises were privatized, some of them partially, and first steps were made towards cutting the deficit in the social security system. Together these measures helped to improve the performance of the Greek economy considerably.

The Convergence Criteria

A country can only join EMU if it has achieved a "high degree of sustainable convergence"[9] with reference to the criteria on price stability, long-term interest rate, public finances, the exchange rate and a number of legal requirements, e.g. the independence of the central bank. Reports by the EU Commission and the European Central Bank have concluded that Greece had fulfilled these requirements by spring 2000 (Table 1):[10]

☐ *Price stability:* Greece recently entered a period of price stability. In particular, inflation during the reference period of April 1999 to March 2000 was 2.0% which was 0.4 percentage points below the reference value as defined in Article 121 (1) TEC. However, the recent decline of inflation is partly due to temporary (administrative) effects, such as a reduction in indirect taxes and informal arrangements between the Greek government and enterprises to reduce selected retail prices.

☐ *Long-term interest rate:* During the reference period the average Greek interest rate was 6.4% which was 0.8 percentage points below the reference value of 7.2%. The reduction of the long-term interest rate can mainly be attributed to decreasing inflation differentials with EMU countries and the improvement of the government debt position. In addition, the prospect of imminent EMU membership has contributed further to the convergence of Greek interest rates to EMU levels as investors have moved from euro bonds into Greek securities.

☐ *Public finance:* As defined in the Treaty on European Community a country fulfills this criterion if it does not have an "excessive deficit". In particular, the fiscal deficit should be below 3% of GDP, the public debt below 60% of GDP. If the fiscal deficit and debt are above the thresholds a country can nevertheless comply with the criterion, as long as deficit and debt are declining sufficiently fast towards these limit values. In the reference year 1999 the Greek public deficit was 1.6% of GDP, clearly below the reference value of 3%. The debt ratio was 104.4%, well above the 60% reference value (but below the debt ratio of the EMU members Italy and Belgium). As the debt ratio has been declining since 1997, the European Council (ECOFIN) made the decision in November 1999 that Greece does not have an "excessive deficit" and is therefore in compliance with the public finance criterion.

☐ *Exchange rate:* In the two-year reference period from April 1998 to March 2000 the drachma participated in the EMS and the Exchange Rate Mechanism II respectively. During that time the drachma fluctuated considerably, but always stayed within the ±15% exchange-rate band thus fulfilling the requirements of the exchange-rate criterion.

Table 1
Convergence Criteria 1999

	Inflation rate		Long-term interest rate		Fiscal deficit (% of GDP)		Public debt (% of GDP)	
Countries	1998	1999	1998	1999	1998	1999	1998	1999
Belgium	1.4	1.4	5.7	5.2	−1.7	−0.9	118.1	114.4
Germany	1.4	1.1	5.6	4.9	−2.5	−1.1	61.2	61.1
Greece	5.2	2.0	9.8	6.4	−2.2	−1.6	107.7	104.4
Spain	1.8	2.5	6.3	5.1	−2.2	−1.1	67.4	63.5
France	1.2	0.9	5.5	5.0	−2.9	−1.8	58.1	58.6
Ireland	1.2	3.1	6.2	5.1	1.1	2.0	59.5	52.4
Italy	1.8	1.9	6.7	5.1	−2.5	−1.9	118.1	114.9
Luxembourg	1.4	1.8	5.6	5.1	1.0	2.4	7.1	6.2
Netherlands	1.8	1.9	5.5	5.0	−1.6	0.5	70.0	63.8
Austria	1.1	0.9	5.6	5.1	−2.3	−2.0	64.7	64.9
Portugal	1.8	1.9	6.2	5.2	−2.2	−2.0	60.0	56.8
Finland	1.3	1.8	5.9	5.1	0.3	2.3	53.6	47.1
Euro area	–	1.4	–	5.0	–	−1.2	–	72.2
Reference value	2.7	2.4	7.80%	7.2	−3.0	−3.0	60.0	60.0

Source: European Economy, No 69, Luxembourg 2000.

[8] European Commission: European Economy No. 67, Luxembourg 1999, p. 79.

[9] Article 121 TEC.

[10] Commission of the European Communities: Convergence Report 2000 (prepared in accordance with Article 122(2) of the Treaty), COM (2000) 277 final, Brussels, May 2000; European Central Bank: Convergence Report 2000, Frankfurt am Main 2000.

Benefits and Costs for Greece

Greece has followed a restrictive stabilization policy in order to be admitted to the EMU. Was it worth the price? Specifically, what can Greece expect to gain from the EMU? In general terms, the costs and benefits of EMU membership have been discussed extensively in the literature.[11] On the microeconomic level Greece should profit in its capital and trade transactions with EMU countries through a reduction of transaction costs. As soon as the drachma is replaced by the euro, the exchange fees and the costs of (protection against) exchange-rate volatility are abolished. This reduction in *transaction costs* is relatively small in the case of Greece, as Greece is one of the least open EU countries. The sum of exports to and imports from EU members amounts to just 18% of GDP.

Competition in the financial sector should intensify when Greece joins EMU. Capital mobility will increase as transaction costs fall and the (small) risk of restrictions on capital transactions will be further reduced with the introduction of a common currency. It will be cheaper for Greek investors to access the bigger euro capital markets, and foreign banks and financial intermediaries will be able to enter Greek financial markets more easily. These developments should help to break up the cartel-like structure of the Greek banking system.

On the macroeconomic level Greece will replace its national monetary and exchange-rate policy by the supranational ECB policy. This should improve the long-run prospects for *price stability*. By "tying its hands" and giving up monetary policy Greece profits directly from the better reputation of the ECB. Although the Greek central bank has recently lowered the inflation rate to EMU levels, it still has reputation problems because of a long tradition of high inflation rates since 1974. In addition, the Greek central bank is more likely to come under political pressure to pursue a more expansionary policy than the supranational ECB. In particular it is easier to change the legal framework and withdraw independence in the case of the Greek central bank than in the case of the ECB, whose independence is guaranteed by the European constitution.

The better prospects for price stability should reduce the *inflation risk premia* on Greek bonds. Nominal and real interest rates should fall further with positive effects on investment and on public debt through lower financing costs.

By giving up its monetary and exchange-rate policy Greece loses important instruments for neutralizing *asymmetric shocks*. If the economic development of Greece deviates from the rest of the euro area, the adjustment process can no longer rely on monetary and exchange-rate policy. The possibility of asymmetric shocks increases with differences in the economic structure between regions. In a number of aspects Greece still differs considerably from the rest of the EMU.[12] Agriculture is relatively important in the Greek economy as is the service sector which is domestically focused and heavily regulated.[13] Also the structure of trade differs from the rest of the EMU, both sectorally with an emphasis on agricultural

[11] E.g. P. DeGrauwe: The Economics of Monetary Integration, 4th ed., Oxford 2000.

[12] K. M. Kletzer: Macroeconomic Stabilization with a Common Currency: Does European Monetary Unification Create a Need for Fiscal Insurance or Federalism?, ZEI Policy Paper B97-04, Bonn 1997; T. Bayoumi, B. Eichengreen: Shocking Aspects of European Monetary Unification, NBER Working Paper 3949, 1992.

[13] J.-C. Bureau, Y. Le Poux: The Economic Consequences of the Agro-food Sector, OECD, Paris 1999.

products, textiles and tourism and regionally with the growing importance of the Balkans as well as Central and Eastern European countries.

From an institutional perspective the loss of monetary autonomy marks an important change. However, de facto the consequences of the change-over to the euro will not be that dramatic because most of the necessary adjustments have already been made in the run-up to EMU. When the Greek government decided to aim for EMU membership and started the first convergence program in 1992 it implicitly gave up its independent national monetary policy. It is the logic of the convergence criteria that future members of EMU have to pursue economic policies as if they already were EMU members. Thus, Greece was only able to fulfill the criterion of price stability because it gave up independent monetary goals and converged to a Bundesbank/ECB-style monetary policy. Thus, Greece has already given up monetary policy autonomy long before joining EMU.

How is EMU going to affect fiscal policy? As in the case of monetary policy Greece has made many of the necessary adjustments before joining EMU. As an EU member Greece has already been required to pursue a prudent fiscal policy according to the procedures of Article 104 TEC. While the EMU members have further specified these procedures through the pact on stability and growth, the restrictions on fiscal policy should not be overestimated. In particular, it is not clear what will happen if a country does not avoid an excessive deficit as there are no means to effectively penalize a member state. In a way fiscal policy is de facto less restricted for an EMU member than for an EMU candidate. If a country wants to join the monetary union the EMU members can sanction a loose fiscal policy by not letting the country join the euro zone. Once the country is admitted to the club there are no effective means of penalizing a too expansionary fiscal policy.[14]

With the restrictions on Greek economic policy, necessary adjustments to asymmetric shocks must work through other channels, either structural policies or more flexible labor and goods markets. There is also a tendency to constrain national structural policies. For instance, the EU commission tries to restrict the use of state aid in the European Union to avoid unfair competition and to safeguard the common market. This leaves the liberalization of goods and labor markets as the main vehicle for guaranteeing flexible adjustment.

Implementing these structural reforms is the main task Greece has to complete on its way into the EMU. Among the important items on this agenda are the liberalization of the markets for energy, telecommunication and transport, greater flexibility of labor markets, privatization of state enterprises, modernization of financial markets, reform of the social security system and the modernization of the public administration.

The Euro Zone Perspective

The present EMU countries can be affected by Greek membership in two ways, by changes in the structure of the euro economy and in the working of ECB policy. Greek participation in EMU will affect the characteristics of the euro economy only slightly. The population in the euro zone will increase by 3.6% and real GDP by around 2%. The efficiency gains due to reduced transaction costs should therefore be rather small for the current EMU members.

What costs does Greek EMU membership impose on the euro zone members? Specifically, are there negative effects for the reputation of the ECB? If economic agents believed that the ECB was going to pursue its goal of price stability less strictly and/or to emphasize other goals, e.g. economic growth, then the costs of a policy of price stability would increase. The inflation/output trade-off would deteriorate and the central bank would have to implement a more restrictive monetary policy to accomplish the same degree of price stability.[15]

Ex ante this possibility cannot be ruled out completely. However, it does not seem to be very likely that monetary policy is going to change with the admission of Greece to EMU. The president of the Greek Central Bank is head of an independent institution and the opportunities to exert political pressure on him are limited. Together with the other 17 members of the ECB council he decides *ad personam* and not as a national representative on monetary policy issues.

There could still be a loss of reputation for the ECB if financial markets believe that the ECB is going to accommodate an expansionary policy by a member country or – as a lender of last resort – is going to bail out a member country to contain a financial crisis. The question then is whether Greece is likely to trigger

[14] See the complex procedures of Article 104 TEC.

[15] R. Barro, D. Gordon: Rules, Discretion and Reputation in a Model on Monetary Policy, in Journal of Monetary Economics, Vol. 12, 1983, pp. 101-121.

such a crisis. Put differently, is the current process of convergence sustainable?

While Greece is in accordance with the convergence criteria, the analysis above made it clear that the EMU requirements have been met only very recently and are partly due to temporary influences. Therefore the question remains whether this situation is sustainable. From a long-term perspective the process of consolidation and macroeconomic adjustment started at the beginning of the 1990s with the first convergence program. Since then there have been constant improvements with respect to inflation and the long-term interest rates. The fiscal deficit has declined since 1993. So whereas the convergence criteria could only be fulfilled recently, the process of convergence has continued for several years.

Currently Greek economic policies are implemented in the framework of the revised convergence plan for the years 1998 to 2002 (see Table 2). The economy is in line with this convergence plan, indicating a sound economic development.

Comparisons with other small European economies might also help to evaluate Greek development. In particular, Ireland seems to be a relevant example. In the 1970s Ireland had the reputation of poor economic policies and an inferior economic development. At the beginning of the 1980s Ireland started an economic turnaround. Taking 1982 as the reference point t_0, the inflation rate was reduced from 10% to 2% within five years and the fiscal deficit from 13% to 2% of GDP with seven years (see Figures 4 and 5). Today, Ireland has a very good reputation for sound economic policies and is *the* high-growth economy in Europe. Does the Greek convergence process match this pattern of economic stabilization? As Figures 4 and 5 indicate, Greece is currently in a process of economic convergence that is very similar to the earlier experiences of Ireland. Taking 1992 as the reference year t_0, Greece has considerably reduced the inflation rate as well as the fiscal deficit within a similar time period. Obviously Ireland and Greece cannot be compared directly as both countries differ in their economic structure and the circumstances under which the stabilization process was implemented. In particular, it is not possible to predict the future development of Greek economic polices. However, the comparison gives some indication that Greece is on an economic policy path that has successfully been completed by an economy with similar policy problems in the past.

Figure 4
Adjustment: Inflation

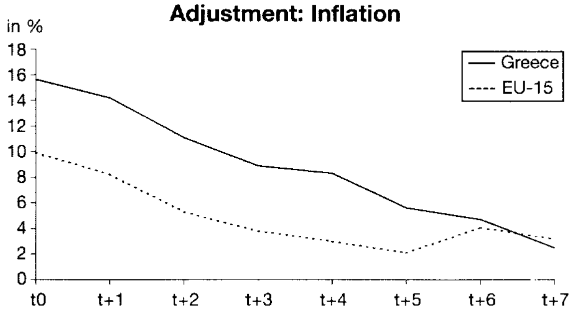
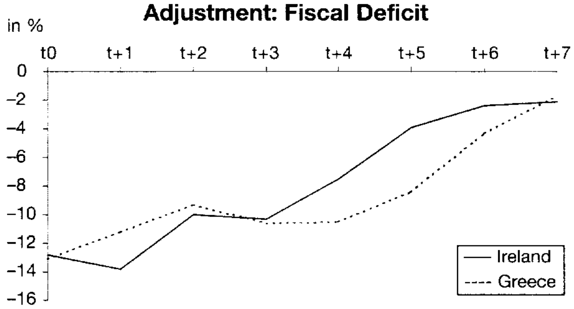


Figure 5
Adjustment: Fiscal Deficit



Remaining Tasks

The Greek aim of EMU membership was made possible by a substantial macroeconomic adjustment process during the 1990s. A tight monetary policy and an increasingly restrictive fiscal policy enabled Greece to comply with the convergence criteria in the year 2000 and to join the EMU. It remains to be seen whether Greece can keep this macroeconomic discipline and whether it is going to continue the necessary liberalizations on the microeconomic level.

The restrictions on autonomous national economic policies call for further deregulation of the Greek economy. Other developments in the EU work in the

Table 2
Updated Convergence Plan (1998-2002)

	1998	1999	2000	2001	2002
Real GDP (% change)	3.7	3.5	3.8	4.1	4.3
Investment (% change)	8.1	8.3	8.6	9.2	9.8
Exports (% change)	4.2	5.4	6.8	7.1	7.2
Imports (% change)	1.9	5.1	3.1	6.3	6.6
Current account (% of GDP)	−1.9	−1.3	−1.8	−2.0	−2.0
Inflation (%)	4.7	2.5	2.1	2.1	2.0
Public deficit (% of GDP)	−2.5	−1.5	−1.2	−0.2	+0.2
Public debt (% GDP)	105.4	104.2	103.0	99.5	98.0
Unemployment rate (%)	10.9	10.5	10.1	9.5	8.7

Source: Greek Ministry for the National Economy.

same direction, independently of the EMU. The completion of the common market and greater mobility of capital and labor put additional pressure on Greece to reform its economy.

The Greek government has responded to these developments. It has announced that it will open the markets for telecommunication (end of 2000) and energy (2001) according to Community law. It also plans to deregulate the markets for transport and the labor and financial markets and to privatize additional public enterprises.[16] Supply-side conditions should further improve through reforms of the social security system and the tax system as well as public administration. The government also plans to redirect state expenditure from public consumption to more productive fields such as research and development or education and training. On the external side a possible stabilization in the Balkans could have particularly positive effects on Greece.

Whether the government is going to succeed with its plans will depend to large degree on the social acceptance of these measures. Currently the political and social conditions are rather favorable. The Greek government and the most important political parties still support the continuing process of economic reform. It remains to be seen whether this consensus will hold when the negative short-run effects of the reform process become more visible than the positive long-run effects. Yet, there is reason to be optimistic. Other small European economies such as Ireland have shown a remarkable ability for economic reform and Greece has demonstrated in the last years that it is willing to go in a similar direction.

[16] K. Simitis, op.cit.; G. Stournaras: Economic Prospects and Economic Policy Requirements in the Euro Zone, Eurobank, Greek Economy 2000, pp. 96-99 (in Greek).

Armin Rohde and Ole Janssen*

Estonia's Monetary Integration into EMU

Estonia is not only striving for rapid acceptance into the European Union, but it is also directing efforts towards being integrated into EMU without delay. The following article first comments on the extent to which the convergence criteria, as the central precondition for admittance to EMU, have been fulfilled. It then proceeds to discuss the compatibility of Estonia's present currency board system with the requirement of its participation in the ERM II. Finally, it looks into the consequences of a premature subjection to the ECB's monetary strategy.

In order to answer the question as to whether Estonia already sufficiently meets the requirements for joining the European Monetary Union (EMU) and thus the integrated euro area, it should first be clarified whether Estonia fulfils the "Copenhagen criteria" agreed on by the European Council in June 1993, in other words the qualifying criteria for being accepted into the European Union (EU) as a new member. For only members of the EU are allowed to participate in EMU. It is true that entry into the EU entails simultaneous acceptance into the Economic and Monetary Union, however with the status of member states to which a derogation applies. This is the position of Denmark, Greece, the United Kingdom and Sweden today.[1] This means that on joining the EU a country takes on a clear obligation to participate in the EMU without derogation at a later date. The precondition for this last step is the fulfilling of the so-called convergence criteria ("Maastricht criteria") according to the Treaty on European Union. Estonia is not only striving for rapid acceptance into the EU, but it is also directing efforts towards being integrated into EMU without delay.

The object of the following is not to assess Estonia's suitability for joining the EU in general political terms according to the "Copenhagen criteria", but rather to analyse the implications of a rapid accession to EMU in terms of monetary policy. To this end a brief

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[1] Denmark and the United Kingdom have opting-out clauses to which the derogations apply. See Claus Köhler: Vertragliche Grundlagen der Europäischen Währungsunion, Volkswirtschaftlicher Kurzkommentar, Berlin 1999, pp. 115 f.